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In the Supreme Court of the United States

OCTOBER TERM, 1993

VICTOR TEICHER, VICTOR TEICHER & CO., AND ROSS FRANKEL, PETITIONERS

v.

UNITED STATES OF AMERICA, RESPONDENT

On Petition for a Writ of Certiorari to the Unites States Court of Appeals for the Second Circuit

PETITIONER'S REPLY BRIEF

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12 pp

TABLE OF AUTHORITIES

Cases **Pages**

Bateman Eichler, Hill Richards, Inc. v. *Berner*, 472 U.S. 299 (1985) 3

Carpenter v. *United States*, 484 U.S. 19 (1987) 2

Chiarella v. *United States*, 445 U.S. 222 (1983) 2

Dirks v. *SEC*, 463 U.S. 646 (1983) 2, 6

SEC v. *Clark*, 915 F.2d 439 (9th Cir. 1990) 2, 3

United States v. *Chestman*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1759 (1992) 4

Miscellaneous

Aldave, *The Misappropriation Theory and its Aftermath*, 49 Ohio St. L.J. 373 (1988) 3

Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 Va. L. Rev. 1023 (1990) 3

Pitt & Groskaufmanis, *Actual Use of InsideInformation at Issue*, Nat'l L.J., June 21, 1993, at 20 9-10

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PETITIONER'S REPLY BRIEF

The Solicitor General entirely fails to come to grips with the arguments for review presented by the petition. He does not deny that the validity of the misappropriation theory of securities fraud raises a recurring and enormously important question that has been reserved by this Court -- and he does not deny that the theory itself has been roundly criticized judges, practitioners, and commentators. He does not deny that the court of appeals' conclusions regarding the "causation" issue (discussed at Pet. 13-27) are inconsistent with the approach taken by this and other courts, and that

those conclusions will disrupt long-settled practices in the securities markets. He does not deny that those conclusions already are affecting behavior in the Second Circuit, the home of the nation's principal securities exchanges. And his analysis of harmless error adds nothing to the court of appeals' insupportable analysis. Review of the decision below therefore is in order.

1. We agree with the Solicitor General, of course, that three courts of appeals (two rather recently) have endorsed the misappropriation theory. See Pet. 11. But the Solicitor General is playing a semantic game when he asserts (at Br. in Op. 9) that neither of this Court's "insider trading" decisions, *Chiarella* v. *United States*, 445 U.S. 222 (1983), and *Dirks* v. *SEC*, 463 U.S. 646 (1983), "rejects the misappropriation theory." In fact, the important point for present purposes is that neither decision provides *any support whatsoever* for the theory (see Pet. 12), as the Solicitor General appears to recognize. To the contrary, *Chiarella* expressly reserved judgment on the validity of the theory. See 445 U.S. at 236-237; *id.* at 238 (Stevens, J., concurring).

Matters obviously were not clarified by this Court's affirmance by an equally divided Court in *Carpenter* v. *United States*, 484 U.S. 19 (1987). The Solicitor General nevertheless confidently opines (at Br. in Op. 10) that "the issue on which the Court was 'divided four-to-four' in *Carpenter* * * * is not the issue presented in this case"; he suggests that the Court was split, not on the validity of the misappropriation theory, but on the application of the theory to the peculiar facts of that case. But he has absolutely no grounds for making that assertion. "Because the sole opinion in [*Carpenter*] does not state the basis for the division, we cannot know whether the four justices who voted to overturn the Rule 10b-5 convictions did so because they rejected the misappropriation theory in general or merely its novel application in the case." *SEC* v. *Clark*, 915 F.2d 439, 446

(9th Cir. 1990) (footnote omitted).[1] And as we explain in the petition (at 11-12) -- notwithstanding the Solicitor General's misplaced confidence -- practitioners, commentators, and a committee of Congress have expressed the view that *Carpenter* left the validity of the theory unresolved.[2]

In these circumstances, review by this Court is imperative. There plainly is substantial reason to doubt the validity of the misappropriation theory: as we explain in the petition (at 12-13) -- and as the Solicitor General does not deny -- the misappropriation approach been challenged as insupportable by a wide cross-section of academics and members of the securities bar.[3] Despite these widely shared

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[1] As one commentator has noted, "[d]ifferent legal experts reacted quite differently to the Court's four-to-four deadlock on the question of whether the *Carpenter* defendants had committed securities fraud. A member of the Securities and Exchange Commission insisted that the Justices had left the misappropriation theory 'alive and well.' A prominent law professor, on the other hand, thought that the decision indicated 'pretty strongly' that the theory was 'a fairly dubious proposition.'" Aldave, *The Misappropriation Theory: Carpenter and its Aftermath*, 49 Ohio St. L.J. 373, 374 (1988) (footnotes omitted).

[2] The Solicitor General suggests (at Br. in Op. 10) that the misappropriation theory is supported by a statement in *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299, 313 n.22 (1985). But even courts that have accepted the misappropriation theory believe that *Bateman Eichler* is not probative on the question: "because the misappropriation theory was not at issue in *Bateman Eichler*, the statement is obviously dictum. Moreover, two years later, when the misappropriation theory was squarely before it, the Supreme Court was evenly divided" in *Carpenter*. *Clark*, 915 F.2d at 453 n.24.

[3] The Solicitor General's sole defense of the misappropriation theory is the bald statement that the use of misappropriated

reservations, the misappropriation theory is being applied aggressively by the SEC and the Justice Department. It recently has been questioned by five judges of the en banc Second Circuit, who nevertheless concluded that "the law is far enough down this road * * * that a court of appeals has no option but to continue the route." *United States* v. *Chestman*, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part), cert. denied, 112 S. Ct. 1759 (1992).[4] Before an issue of such importance is settled by default, it should be addressed by this Court.

2. The court of appeals, after a lengthy analysis of the causation issue (see Pet. App. 16a-19a), concluded that "a

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information in trading "satisfies the 'in connection with' requirement" of Rule 10b-5 "because the very reason for misappropriating the information is to take advantage of it in a securities transaction. To the misappropriator, the information 'has no value whatsoever except "in connection with" his subsequent purchase of securities.'" Br. in Op. 11-12 (citation omitted). See *id.* at 8-9. As commentators have explained, however, this analysis "simply does not square well with the doctrinal structure of Rule 10b-5, which seems to speak largely in terms of protecting the integrity of the investment decisions of *buyers or sellers* of securities." Langevoort, *Investment Analysts and the Law if Insider Trading*, 76 Va. L. Rev. 1023, 1035 n.43 (1990). The Solicitor General's analysis likewise finds no support in *Chiarella* and *Dirks*, which defined the insider trading offense as involving a fraud on the *purchaser or seller* of securities. See Pet. 12. It may be added that the Solicitor General's analysis would have led to affirmance of the conviction in *Carpenter* -- and the one thing we can draw with certainty from the outcome in that case accordingly is that the Solicitor General's theory was rejected by four Justices.

[4] The petition for a writ of certiorari in *Chestman* did not challenge the misappropriation theory; it presented a question concerning the SEC's rulemaking authority under Section 14(e) of the Securities Exchange Act of 1934. See Pet. No. 91-1085, at i.

requirement of a causal connection between the information and the trade could frustrate attempts to distinguish between legitimate trades and those conducted in connection with inside information." *Id.* at 19a. As we explain in the petition, this conclusion cannot be reconciled with concepts of fraud recognized by this and other courts (see Pet. 14-16); is inconsistent with what had been the uniform understanding of the law among courts and securities law practitioners (see Pet. 16-19); and will disrupt long-settled and socially beneficial practices in the securities markets (see Pet. 21-25). The Solicitor General takes issue with *none* of those propositions. And notwithstanding the Solicitor General's elaborate statement of facts, he does not (and could not) deny that evidence placed before the jury supported the view that the trades at issue were motivated by publicly available information (see Pet. 5) -- and that several of the trades (all of which were charged as separate offenses) were flatly *inconsistent* with the tips received by petitioners (see *ibid.*).[5]

We also explain in the petition (at Pet. 25-27) that the court of appeals' assertion of a harmless error analysis was illusory because the court relied on considerations that will be present in practically *every* case. The Solicitor General's boilerplate defense of the court's conclusion as a "factbound" one (Br. in Op. 12) that "does not have importance that transcends the facts of this case" (*id.* at 14) therefore misses the

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[5] To offer just two examples that are ignored by the Solicitor General: Teicher sold all of his shares of American Can the day after purchasing them, even though he allegedly had been tipped that a takeover attempt would take place "within six months" if "at all" (see Pet. 5); and Teicher sold shares of Revco short at a price *below* what he had been told would be bid in a leveraged buyout -- a position that would have exposed him to substantial losses had the tip been correct (see *ibid.*). Needless to say, there is reason to doubt that a trader relied on a tip when he acted inconsistently with it.

point. As we explain in the petition (at 25-26), the court of appeals' analysis establishes a *legally conclusive presumption* that any securities professional who trades while in possession of material nonpublic information relied on that information. The court of appeals' conclusions regarding causation and harmless error thus are not analytically distinct: if this Court finds that causation is an element of the charged offenses, the Second Circuit's harmless error analysis could not survive.

The Solicitor General's suggestion that "the court based its harmless error holding on the specific circumstances of this case" (Br. in Op. 13) adds nothing to the court of appeals' analysis. Like the court below, the Solicitor General points to the following "specific circumstances" as supporting the finding of harmless error: petitioners were arbitrageurs who attempted to "accumulat[e] as much information as possible" about stocks and "sought out whatever tidbits of information they could to assist in that task" (Br. in Op. 14); and petitioners "knowingly had in their hands material information relating to the stock" (*ibid.*).[6] But those factors invariably will be present in a securities fraud prosecution.

The defendants in such prosecutions, after all, typically are arbitrageurs, analysts, or other knowledgeable market

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[6] The Solicitor General also reads the court of appeals' opinion as stating that petitioners "did not present as their theory of defense that they did not rely on the information." Br. in Op. 14. That is a misreading of the decision below. The court's discussion of petitioners' presentation at trial was designed to establish that petitioners' defense of lack of scienter was presented to, and rejected by, the jury; the court observed that "[i]n fact, the question of what Teicher and Frankel believed about the tipped information was properly placed before the jury." Pet. App. 20a. But the court did not find that petitioners failed also to present a non-causation defense. To the contrary, as the district court observed, "significant reliance upon licit[,] noninvidious reasons for trading" was "at the heart of the defense position" at trial. J.A. 954.

participants who "sought out" information to assist in their trading. Indeed, as we explain in the petition (at 21-23), the court of appeals' rule is particularly harmful precisely because it *is* applied to such professionals, whose information-seeking activity has been encouraged by the courts and the SEC; the decision below thus plainly will have the "inhibiting influence on the role of market analysts" that concerned the Court in *Dirks*. 463 U.S. at 658. And in *every* case the jury will have to find scienter (that is, knowing possession of material nonpublic information) to convict. If such a finding necessarily establishes use of the nonpublic information by a securities professional, as the court of appeals held in concluding that "no reasonable jury" could find otherwise (Pet. App. 21a), the government never will have to prove more than possession. The Solicitor General pointedly does not contend otherwise. To the contrary, it is telling that the Solicitor General's sole defense of the merits of the court's analysis of the causation issue -- that "[m]aterial information in the mind of a securities trader is inevitably used in the process of a trading decision" (Br. in Op. 14 n.9) -- is *identical* to his defense of the court's harmless error analysis.[7]

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[7] It bears emphasis that the government's approach suffers from a fatal internal inconsistency that points up the necessity for this Court to settle the nature of the misappropriation theory. The government asserts that causation is not an element of the securities fraud offense. But as we explain above (at note 3), the government's defense of the misappropriation theory rests entirely on the ground that the "in connection with" requirement of Rule 10b-5 is satisfied "because the very reason for misappropriating the information *is to take advantage of it in a securities transaction*." Br. in Op. 11-12 (emphasis added). The government thus recognizes that the misappropriation theory may come into play only when the defendant *used* the nonpublic information in trading. As a consequence, at least one of the government's two submissions to this Court must be wrong: either the

Pointing to the standard charge on scienter given to the jury, the Solicitor General does assert (at Br. in Op. 13-14) that the instruction effectively required the jury to find that "petitioners had traded on the basis of information that they knew was unlawfully acquired." That assertion, however, represents a complete reversal of the government's position. In response to defense arguments that the proposed instructions were flawed because they did not require proof of causation, the government argued in the district court:

> How could the government police the law if [defense counsel] is correct? *It creates enormous enforcement problems*.
>
> I think your Honor is absolutely correct, and that is precisely right, if Mr. Salsbury [the alleged tipper] made the call while Mr. Teicher had already made some decision to trade [Teicher] would be precluded from trading. *And that is because the government would never be able to prove what was in his mind or wasn't in his mind before he got that call from Salsbury*.

J.A. 1595 (emphasis added). Notwithstanding defense counsel's complaint that "[b]ecause the government can't prove something we're going to convert it into a crime?" (*ibid.*), the district court gave the instruction sought by the government. Having persuaded the district court to instruct the jury that proof of causation is *not* necessary because otherwise "the government never would be able to prove" its case, the government should not be able to defeat review in this Court by arguing now that the instructions actually given *required* the jury to find causation.

Finally, it bears emphasis that the decision below effectively establishes that lack of causation will not be

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misappropriation theory is invalid or causation must be proved.

accepted as a defense to a charge of securities fraud in the Second Circuit. As we explain in the petition (at 26-27), participants in the market know that they face criminal prosecution and civil enforcement actions for trading while in possession of inside information, even though the information is not the basis for their trades. In light of the opinion below, those market participants also know that their convictions will be upheld. As a result, market participants *already* are conforming their conduct to the standards laid down by the court below. The Solicitor General does not -- and, given the positions taken by the government in this case, plainly could not -- deny any of this. Because the decision below is having a significant and harmful effect on the operation of the nation's principal securities markets, review by this Court is in order.[8]

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[8] Quoting from Pitt & Groskaufmanis, *Actual Use of Inside Information at Issue*, Nat'l L.J., June 21, 1993, at 20, 22, the Solicitor General suggests (at Br. in Op. 12 n.8) that the court of appeals' discussion of the causation issue was "tentative" and therefore does not warrant review. The Solicitor General's quotations are snipped from their context, however. In fact, the conclusions of the cited article are that the effects of the decision below will be "profoundly" felt "in the day-to-day efforts by market participants" (Pitt & Groskaufmanis, *supra*, at 20); that the decision "alters the environment in which judgments of risk are made by all market participants" (*id.* at 22); that the decision "casts a shadow over industry conventions that have focused on what steps were taken to ensure that [nonpublic] information was not used in making an investment decision" (*ibid.*); and that the decision's legacy may "be a reassessment of some of the basic operating principles of the securities markets" (*ibid.*). The Solicitor General denies none of these propositions.

For the foregoing reasons and the reasons stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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